
OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Information Requested in Relation to the Delayed Financial Statement Audit for Fiscal Year 2010

OVERVIEW

In a memorandum dated March 1, 2011, the Chief Financial Officer (CFO) notified the City Council that the issuance of FY 2010 Comprehensive Annual Financial Report (CAFR) and the associated audit would be further delayed. Citing financial system programming work and accounting adjustments that took longer than originally anticipated, the projected timeframe for a completed/audited FY 2010 CAFR was pushed back from the fourth quarter of FY 2011 to July or August of 2011.

On March 7, 2011, the City's outside auditor Macias Gini & O'Connell (MGO) provided the Audit Committee with an update regarding their plans to audit the FY 2010 CAFR and perform the City's Single Audit. Following MGO's presentation, the CFO briefed the Committee on her March 1st memo and the City Comptroller explained the work of his department to address the accounting adjustments needed to issue the FY 2010 CAFR. In response to these presentations, the Audit Committee expressed concern regarding the extended timeframe for completion of the FY 2010 CAFR.

A special meeting of the Audit Committee was requested on March 21st to receive a status report on fixing the SAP data errors and the latest schedule to issue the FY2010 CAFR. Councilmember DeMaio requested a report from the CFO and Independent Budget Analyst outlining the reports and filings the City is making with incomplete financial data, and what statements the City is making in those filings and reports. Additionally, Councilmember DeMaio requested the Independent Budget Analyst personally follow up with the rating agencies and comment on the City's strategy and approach for disclosure of financial information. This report responds to Councilmember DeMaio's request.

FISCAL/POLICY DISCUSSION

Reports and Filings the City is Making with Incomplete Financial Data

Ongoing or Continuing Disclosure:

The City is obligated to report certain information relating to its outstanding bonds to bond market participants on an annual basis. Section 9.3 of the City's Debt Policy says the following about this responsibility:

"The City will provide full and complete financial disclosure to rating agencies, institutional and individual investors, other levels of government, and the general public to share clear, comprehensible, and accurate financial information using the appropriate channels/policies/procedures."

When the City publicly issues bonds, it always commits to annually disclose certain information that may be of interest to the financial marketplace (holders of the City's bonds or potential buyers in the secondary market). This obligation to file an Annual Report is referred to as ongoing or continuing disclosure and typically includes submission of the City's audited annual financial statements for the previous fiscal year. Annual Report dissemination due dates for FY 2010 are in late March and early April of 2011 (Attachment 1). The City is responsible for providing ongoing disclosure information to the Municipal Securities Rulemaking Board's (MSRB's) Electronic Municipal Market Access (EMMA) system.

All City financial market disclosure is reviewed by the City's Disclosure Practices Working Group (DPWG) prior to dissemination. If the City does not have audited annual financial statements from the prior year in time to submit its Annual Report, staff instead files a Notice of Failure to File Annual Report with EMMA. Once the City receives its audited CAFR, it will then file the complete Annual Report with EMMA to include the financial statements along with other required prior year financial and operating data.

On March 16, 2011, the DPWG reviewed the following draft language that is to be included in the Notice of Failure to File Annual Reports for General Fund backed, Wastewater and Water bonds. The Notices are scheduled for submission to EMMA over the next few weeks.

"NOTICE IS HEREBY GIVEN that as of March XX, 2011 the City of San Diego has concluded it will not be able to file its Annual Reports for the fiscal year ended June 30, 2010 with respect to the bonds referenced above by March 27, 2011 (Water and Sewer Obligations), and April 11, 2011 (General Fund Backed Obligations), in accordance with the respective continuing disclosure agreements. The preparation of the City's Comprehensive Annual Financial Report ("CAFR") for the fiscal year ending June 30, 2010 has been delayed due to technical difficulties encountered during the implementation of a new enterprise resource planning system. The City expects to release the CAFR, including audited financial statements, in July or August 2011 at which time the Annual Reports, including the CAFR, will be transmitted to EMMA."

For Community Facilities District, Assessment District, and Tobacco Settlement bonds, the City will file a timely Annual Report in 2011 with all of the other required prior year financial and operating data, but without the audited FY 2010 financial statements. These Annual Reports will note the unavailability of the audited FY 2010 CAFR using language similar to the above language for General Fund backed and Water/Wastewater bonds. The City will subsequently provide its audited FY 2010 CAFR when it is received.

Investor Information Webpage:

The City has created and maintains an Investor Information Webpage as another means of providing pertinent information to the financial marketplace. The Webpage is easily accessed from the City Homepage and provides an excellent source of information for financial market participants and the public. When the City makes a disclosure that is judged to be of particular interest to the financial marketplace, management may elect to post the disclosure on the Investor Information Webpage. All postings to the Investor Information Webpage are first reviewed by the DPWG with input from the City's Outside Disclosure Counsel. With respect to recent disclosure related to the additional delay in releasing the audited FY 2010 CAFR, management posted an Updated Message to Investors from the Chief Financial Officer dated March 8, 2011 (Attachment 2).

Notifications Related to the Delay in the City's Single Audit:

All non-Federal entities that expend \$500,000 or more of Federal awards in a year are required to obtain an annual audit in accordance with the Single Audit Act. As the City expends more than \$500,000 of Federal awards annually, the federal Office of Management and Budget (OMB) requires the City obtain a single audit by March 31st of each year. A single audit is intended to provide a cost-effective audit for non-Federal entities in that one audit is conducted in lieu of multiple audits of individual programs.

In order to perform the single audit for the City, MGO reviews risk assessment parameters established by the OMB in order to determine the scope of the audit. The City is currently defined as a high-risk auditee and therefore requires that at least 50% of program expenditures be audited. MGO has not completed the FY 2010 CAFR audit and is in the process of performing testwork on 4 of the 13 major programs selected for the City's FY 2010 single audit, thus the City will not meet the OMB deadline of March 31, 2011. There is no immediate implication to missing this deadline; however, failure to meet this deadline becomes a contributing factor that will maintain the City's status as a high-risk auditee for a minimum of two more years; may result in delayed or rescinded funding; and could result in additional oversight reviews from federal and state grantors.

While there is no requirement to issue a report or filing in connection with a delayed single audit, MGO informed the IBA that the City may wish to notify its cognizant agency (HUD). OMB Circular A-133 defines the cognizant agency for audit as a federal agency designated to carry out the federal responsibilities with regard to a single audit. Unlike the requirement to submit Annual Reports to EMMA for bonds, notifying the City's cognizant agency is optional and the City has historically not elected to do this.

Feedback from the Rating Agencies

In response to the request from Councilmember DeMaio, the IBA contacted each of the three major rating agencies on March 11, 2011. In each case we spoke with the director or vice president who has lead responsibility for analyzing the City's credit. We asked each representative 1) if they had received a copy of the March 1st memorandum from the CFO, 2) if they had any concerns or questions related to the delay of the FY 2010 CAFR, 3) if they were satisfied with the communication with the City and 4) if they required any additional information from the City regarding this matter.

In general, the rating agency representatives were comfortable with the communication they had received from the City regarding the delayed financial statements for FY 2010. All had received and reviewed the March 1st memorandum from the CFO. While they were understanding of delays attributed to major financial system overhauls, they continue to monitor the City's situation and one representative questioned why the problem was taking so long to resolve. The rating agencies expect the City's CFO and Debt Management Director to apprise them of any significant developments associated with delays in issuing the FY 2010 CAFR. In evaluating the delay, Fitch recently requested and received information from the CFO related to the City's FY 2010 and FY 2011 budgets, the relationships between the two budgets and questioned why the City's old and new financial management systems had not been run in parallel during the transition period.

A few quotes which summarize the discussions with each rating agency representative are provided below:

Standard & Poor's (Sussan Corson, Director)

- "software implementation delays are not unusual in other cities"
- "this is nothing that sets off alarm bells for us"
- "this is very different from the delays of the past"
- "we would be interested in any major restatements in the City's financial statements"

Fitch Ratings (Alan Gibson, Director)

- "there has been good communication back and forth with the City"
- "we don't want to signal a problem if this is just a system related problem"
- "following the timely release of the FY 2009 CAFR after years of delayed City CAFRs, the delay of the FY 2010 CAFR could be viewed as a retrograde step with some reputational risk to the City"
- "a 20-month gap since the last audited fiscal year is a red flag; however, the information that has been provided to Fitch is a big help"
- "I do wonder why the needed accounting fixes are so problematic, why they have taken this long and whether management has dealt with this as expeditiously as possible"

Moody's (Kev Khrimian, Vice President)

- "at this point we view the CAFR delay as a minor credit factor; however, not enough to make a fundamental credit change"
- "not a positive thing, but not fatal"
- "audited CAFRs are good sources of information, but not the only sources; good reliable information is what we care about"
- "we try to understand the causes of the delays and this sounds more technical in nature"
- "appreciate that the City has improved its data oversight systems; information is slow to get out but what gets out is accurate and reliable"

In summary, the rating agencies appreciated receiving significant information and updates related to the delayed issuance of the FY 2010 CAFR. They understand delays attributed to major changes in financial systems; however, they continue to monitor the City's problem and would be increasingly concerned if the problem is not resolved as currently projected.

Additional Considerations Related to Delayed Financial Statements

- In presenting their update to the Audit Committee on March 7th, MGO indicated that the unanticipated delay in their ability to conduct the FY 2010 CAFR audit was necessarily going to result in changes to the scope and cost associated with the audit. The IBA was informed that MGO is currently re-evaluating their initial risk assessment to consider the cause and effects of the delay in the audit process. They are considering the additional resources necessary to evaluate the implementation of the new financial accounting and reporting system (SAP) and effects of the payroll allocation errors discovered subsequent to implementation. Although additional costs associated with a modified scope of work have yet to be quantified/requested, the delay may result in a more costly audit.
- On March 16, 2011, the City Comptroller provided an update to the Budget & Finance Committee regarding the efforts to produce financial statements for FY 2010. The Comptroller had previously informed the Audit Committee that he expected to be dealing with unknown issues (associated with correcting labor distribution charges for FY 2010) until March 16, 2011. In briefing the Budget & Finance Committee, he disclosed that his staff had encountered a few additional issues that needed to be addressed and that the period of dealing with unknown issues had now pushed back two weeks until the end of March. The Comptroller noted, however, that he believed his staff was down to the last elements of the needed corrections and thereafter would be entering into a period of known processes associated with closing the books for FY 2010.
- Earlier in the Budget & Finance Committee meeting on March 16, 2011 Councilmember Gloria asked the Debt Management Director if the delayed FY 2010 financial statements precluded the City from issuing bonds to either finance needed capital projects or realize annual debt service savings (management discontinued two refunding efforts late in 2010 when interest rates were lower due to the unavailability of financial statements). The Debt Management Director

indicated she did not anticipate a need for new money bonds in 2011. She further stated that current interest rate levels would not result in the required savings thresholds cited in the City's Debt Policy to issue refunding bonds in order to achieve annual debt service savings. It should be noted that the unavailability of financial statements could hinder efforts to issue refunding bonds in the public capital markets if interest rates were to fall significantly from current levels.

CONCLUSION

In response to a request from Councilmember DeMaio at the Audit Committee meeting on March 7, 2011, the IBA issued this report to summarize reports and notifications the City is making related to the delayed financial statements for FY 2010. Additionally, he requested the Independent Budget Analyst to personally check-in with the rating agencies regarding their thoughts concerning the delayed financial statements. Councilmember DeMaio further asked the IBA to comment on the City's strategy and approach for the disclosure of financial information.

With respect to reports and notifications, this report comments on the process and language used in fulfilling the City's annual reporting requirements to the Electronic Municipal Market Access (EMMA) system for City issued bonds. A copy of the most recent posting to the City's Investor Information Webpage is also discussed and attached. Finally, we mention an option to provide notification regarding the City's inability to complete its FY 2010 Single Audit in time to meet the Office of Management and Budget's deadline of March 31, 2011.

The IBA contacted the three major rating agencies. We spoke with the directors or vice president with lead responsibility for analyzing the City's credit. In summary, the rating agencies appreciated receiving significant information and updates from the City related to the delayed issuance of the FY 2010 CAFR. They understand delays attributed to major changes in financial systems; however, they continue to monitor the City's problem and would be increasingly concerned if the problem is not resolved as currently projected.

This report also raises additional considerations related to delayed financial statements: the cost of the FY 2010 audit; changes in the Comptroller's timeline for correcting labor distribution charges for FY 2010; and the City's need and ability to issue bonds in 2011. The IBA will defer to the City's Outside Disclosure Counsel (John McNally) for comments on the City's strategy and approach for disclosure of financial information.

[SIGNED]

Jeff Kavar
Fiscal & Policy Analyst

[SIGNED]

APPROVED: Andrea Tevlin
Independent Budget Analyst

Attachments: 1. Annual Report Dissemination Date for FY2010/Calendar Year 2011
2. Updated Message for Investors from Chief Financial Officer